COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF EAST KENTUCKY POWER COOPERATIVE, INC. TO ADJUST ELECTRIC RATES) CASE NO. 94-336

O R D E R

On November 21, 1994, East Kentucky Power Cooperative, Inc. ("East Kentucky") filed an application to reduce its wholesale electric rates for service rendered on and after December 31, 1994. The proposed rates would reduce annual revenues by $28,005,363, a decrease of approximately 8 percent from normalized test-year operating revenues. East Kentucky attributed the proposed reduction to declining interest rates, restructuring of its debt with the Federal Financing Bank ("FFB"), and increased power sales. This Order authorizes a decrease in revenues of $33,493,930, a decrease of approximately 9.5 percent from normalized test-year operating revenues.

On December 16, 1994, the proposed rates were suspended for one day and allowed to become effective on January 1, 1995 subject to change by the Commission. Motions to intervene of the Attorney General of the Commonwealth of Kentucky ("AG") and the Kentucky Industrial Utility Customers were granted. A public hearing was held on March 28 and 29, 1995. All information requested at the public hearing has been filed.

COMMENTARY

East Kentucky is a cooperative corporation which generates and transmits electric energy for sale at wholesale to 18 member distribution cooperatives which jointly own it. The member cooperatives purchase their total power requirements from East Kentucky and distribute the power to approximately 367,000 retail customers in 89 central and eastern Kentucky counties. The impact of the revenue decrease on the member cooperatives' annual purchased power costs is set forth in Appendix A.

TEST PERIOD

East Kentucky proposed the 12 months ending December 31, 1993 as the test period for determining the reasonableness of its proposed rates. It also proposed several adjustments to reflect events scheduled to occur a year or more after test-year end. As the application was not filed until almost 11 months after test-year end, most of those events have now occurred.

East Kentucky acknowledged that this approach was unconventional in proposing to recognize the cost impacts of major new facilities under construction but not in service during the test year. It stated that it could have applied a strict historic test-year approach in this case, resulting in a larger rate decrease, and then quickly filed another case to increase rates when the new facilities were placed in service. Instead, it proposed that the Commission recognize post-test-year adjustments relating to its new Combustion Turbine ("CT") project, consisting of three 100 MW units, and the facilities constructed to serve

Gallatin Steel Company ("Gallatin"), which would be in service by the end of this case. East Kentucky proposed this alternative as being in the best interests of its members and their customers by eliminating the disruptive effect of quick, conflicting changes in rates, and the costs of another rate case.[1]

The AG criticized several of the proposed post-test-year adjustments, but accepted those to recognize the CT project and Gallatin. Although these latter adjustments occur well beyond the test year, the AG accepted them because they were scheduled to have occurred by the time this case is adjudicated and it is important to avoid sending customers conflicting pricing signals through rate reductions quickly followed by rate increases.[2] In addition, East Kentucky and the AG modified their original positions to reach full agreement on 12 proposed adjustments, and partial agreement on others.[3]

When a rate case is based on a historic test period, proposed adjustments are evaluated to determine if they are known, measurable, and reasonable. Post-test-year adjustments reflecting events not due to occur until several months after test-year end are usually rejected when their components are estimated rather than actual amounts. Some of the post-test-year adjustments

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1 East Kentucky Brief, at 5.

2 Transcript of Evidence ("T.E."), Vol. II, March 29, 1995, at 42 - 43.

3 East Kentucky Brief, at 6 through 9.

proposed by East Kentucky and the AG would ordinarily be rejected for this reason.

For the CT project and Gallatin, East Kentucky and the AG have also apparently abandoned the matching principle. Under well-established rate-making policy, a historic test period is not adjusted to reflect post test-period plant unless all revenues, expenses, rate base, and capital items have been adjusted to reflect the same time periods.[4] Neither East Kentucky nor the AG proposed all of the requisite adjustments. However, Gallatin and especially the CT project represent significant additions to East Kentucky's plant in service.

Both East Kentucky and the AG maintain that a strict application of the historic test year would produce a larger revenue reduction which in turn would trigger a filing for a rate increase within the near future. East Kentucky's current Equity Development Plan ("Equity Plan") projects its next rate increase to occur in 1998,[5] but the increase would likely occur earlier if post-test year plant were not now recognized. Under these circumstances, it is reasonable to accept the test period ending December 31, 1993 and the post-test-year adjustments for the CT

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[4] Case No. 10201, Adjustment of Rates of Columbia Gas of Kentucky, Inc., Order dated August 23, 1989, at 6; and Case No. 10481, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective on February 2, 1989, Order dated August 22, 1989, at 5.

[5] Response to the Commission's Order dated October 26, 1994, Item 2, at 44 of 77, document titled "Twenty-Year Financial Forecast, Equity Development Plan, 1995-2014, November 1994."

project, Gallatin, and 12 others agreed to by East Kentucky and the AG. The Commission is not abandoning traditional rate-making concepts associated with the historic test period, but is recognizing the unique circumstances in this case.

Although the Gallatin facilities are now in service, East Kentucky notified the Commission on June 28, 1995, that the manufacturer of the CT had issued a "stop work" order on the project due to a turbine blade failure in a similar unit installed by another utility. An informal conference was held on July 5, 1995 to discuss the implications for the rate case of anticipated six to nine month delay in the project's in-service date. East Kentucky subsequently notified the Commission on July 10, 1995 that it had agreed with the parties to reduce its rates temporarily, by a monthly credit to customers' bills, to exclude the CT costs. This monthly credit will be reduced by one-third as each of the three units in the CT project enters commercial service. This credit appears reasonable and will be accepted.

VALUATION

East Kentucky proposed net investment rate base and capital structure as the valuation methods in this case.

Net Investment

East Kentucky proposed a net investment rate base of $676,005,598 based on the test-year-end value of plant in service, CWIP, and the 13-month average for materials, supplies, and prepayments. It excluded adjusted accumulated depreciation. East Kentucky included post-test-year plant adjustments for the CT project and improvements to the Spurlock Power Station ("Spurlock") made during the Inland Container Corporation ("Inland") project. It also proposed to include working capital based on one-eighth of adjusted operating and maintenance expenses, exclusive of depreciation, taxes, interest, and other deductions.

The Commission concurs with these proposals with the following exceptions. East Kentucky and the AG agreed that the post-test-year adjustment to reflect the long-term debt on the Spurlock improvements should not be incorporated into rates. Therefore, it would be inappropriate to include the Spurlock improvements in East Kentucky's net investment rate base. Working capital has been adjusted to reflect the pro forma adjustments to operating and maintenance expenses found reasonable in this Order.

Based on these adjustments, East Kentucky's net investment rate base for rate-making purposes is as follows:

Utility Plant in Service	$934,411,590
Construction Work in Progress	19,008,281
Total Plant in Service	$953,419,871
Add:	
Materials and Supplies	16,517,639
Prepayments	1,773,778
Fuel Stock	12,867,957
Cash Working Capital	21,084,909
Subtotal	$ 52,244,283
Deduct:	
Accumulated Depreciation	$342,790,962
Net Investment Rate Base	$662,873,192

Capital Structure

The Commission finds that for rate-making purposes, East Kentucky's test-year-end capitalization was $740,417,697 with a capital structure consisting of $46,974,298 in equity and

$693,443,399 in long-term debt. This debt balance reflects the January 3, 1994 retirement of FFB notes totaling $72,242,827 and the exclusion of a sick leave reserve of $3,200,000. While the reserve is a liability, East Kentucky failed to cite any provision of the Uniform System of Accounts to support its classification as a long-term debt.

REVENUES AND EXPENSES

East Kentucky proposed several adjustments to revenues and expenses to reflect current and expected operating conditions. The proposed adjustments are generally acceptable for rate-making purposes, with the following modifications:

Revenue Normalization

East Kentucky's per books test-year operating revenues were $344,379,928. It proposed normalized operating revenues of $349,612,134 based on the rates in effect at the end of the test period, including the 40 percent Economic Development Rate ("EDR") discounts in effect for Inland. In doing so, it recognized the May 1993 change in its base fuel rate, which increased revenues by $5,682,711, and the change by three large volume customers to different wholesale rate schedules, which decreased revenues by $450,505.

The AG argued that the EDR discounts should be reduced to reflect a blend of the 30 percent and 20 percent rates in effect during 1995. East Kentucky responded by proposing 30 percent, the rate now in effect. East Kentucky's proposal is more consistent with accepted practice recognizing adjustments that occur while a case is pending and it fairly balances the interests of the parties. This adjustment, which increases revenues by $296,522, should be accepted.

The AG also opposed recognizing decreased revenues from three customers switching rate schedules, arguing that such recognition be conditioned upon East Kentucky's showing that its 1994 net margins for customers served on Rate Schedules B and C were less than the comparable 1993 net margins. The AG contends that absent such a showing, the adjustment effectively ignores the continuing customer growth experienced by East Kentucky's member cooperatives.

The Commission finds no basis to tie this adjustment to changes in net margins or customer growth. Recognizing the revenue impact of these customers switching tariffs is consistent with normalizing revenues to reflect current rates. The adjustment is reasonable and should be accepted.

The AG proposed to increase net revenues by $2,421,456[6] to recognize test year growth in the number of retail customers supplied by East Kentucky. The adjustment was based on test-year sales and year-end customers and fuel costs. In rebuttal, East Kentucky offered to increase net revenue by $1,474,732 to reflect sales adjusted for normal weather and variable O&M production costs.

The AG's adjustment is reasonable and consistent with customer growth adjustments approved for other utilities except that it

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[6] The AG's adjustment would increase revenues by $3,483,262 and expenses by $1,061,806 for a net increase of $2,421,456.

omits variable O&M production costs. While East Kentucky did reflect these costs, it failed to support the weather normalization component.[7] The AG's adjustment, modified to reflect variable O&M production costs of $270,172, increases net revenues by $2,151,284, and should be accepted.[8]

In addition, the Commission has included East Kentucky's estimated margins for Gallatin of $2,567,412 as an adjustment to increase operating revenues. These adjustments result in normalized operating revenues of $354,233,226, an increase of $9,053,298 over test-year actual revenues.

Interest Income

East Kentucky proposed to normalize its interest income to reflect test-year-end balances and interest rates, resulting in a reduction of $7,815,197. The AG proposed to reduce test-year interest income by $3,000,723, based on an estimated short-term investment balance as of December 31, 1994, and interest rates as of February 23, 1995.[9] However, use of these dates is inconsistent with the test year and violates a basic rate-making tenent of matching rate base, capitalization, revenues and expenses for the same time period.

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[7] The Commission has consistently rejected weather normalization adjustments proposed in electric utility rate cases.

[8] The amount of gross revenues of $3,483,262 is unchanged from the AG's proposal.

[9] DeWard Direct Testimony, Schedule 20.

It appears that East Kentucky has understated its short-term investments balance. The Commission has recalculated interest income using test-year-end balances and interest rates. Using a short-term investments balance of $46,582,347,[10] interest income should be reduced $7,305,702.

Kentucky Utilities' Wheeling Charges

East Kentucky proposed to increase operating expenses by $1,664,212 based on a Kentucky Utilities Company ("KU") transmission charge proposal filed with and allowed to go into effect by the Federal Energy Regulatory Commission ("FERC").[11] The AG opposed the adjustment as not final and, as such, not meeting the known and measurable standard.

In its post-hearing brief, East Kentucky indicated that it had settled with KU on the FERC transmission charge, resulting in an annual increase in expense of $673,284. This increase is known and measurable and should be accepted.

Depreciation Expense

East Kentucky proposed to normalize its depreciation expense, resulting in an increase of $1,365,938. The proposed adjustment is reasonable and should be accepted. During review, it was disclosed that East Kentucky has never performed a depreciation study.

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[10] Test-year-end account balance minus FFB debt payment and non-recurring gain on sale of investments ($132,100,919 - $72,242,827 - $13,275,745 = $46,582,347).

[11] At the hearing East Kentucky identified an error in its original calculation. The corrected calculation increases expenses by $2,024,780.

It is required to follow the Rural Electrification Administration ("REA", now Rural Utilities Service "RUS") Bulletin 183-1, Depreciation Rates and Procedures, which was issued on October 28, 1977. As a result of the Bulletin's age, East Kentucky has obtained permission to deviate from its requirements for several plant categories. In many instances, the deviations are not based on a depreciation study.[12]

The original cost of East Kentucky's utility plant in service exceeds $900 million[13] and this capital investment should be adequately recovered over the life of the equipment. Given the age of the Bulletin and the level of investment in utility plant, East Kentucky should perform a complete depreciation study of all utility plant within two years and file a copy of the study with the Commission.

Property Taxes

East Kentucky proposed to normalize its test-year property tax expense, resulting in an increase of $256,276. However, it indicated that the proposed adjustment included taxes for the J. K. Smith Plant,[14] which was canceled and reclassified on East Kentucky's books as non-utility property. The Commission has

[12] Response to the Commission's Order dated December 14, 1994, Item 90.

[13] Application Exhibit B.

[14] Response to the Commission's Order dated December 14, 1994, Item 16(d).

therefore recalculated the adjustment to exclude those taxes, resulting in an increase in test-year expenses of $101,057.

Advertising Expense

East Kentucky proposed to reduce advertising expenses by $376,367, to remove all industrial development advertising and 50 percent of the remaining advertising expenses. The 50 percent amount was based on judgment rather than a detailed analysis,[15] and reflected the fact that the advertising promotes demand side management ("DSM") through energy efficiency and conservation as well as promoting the use of electricity.[16]

The AG proposed to remove all advertising expenses for the Electric Thermal Storage ("ETS") program. He contends that the ETS program is a marketing, rather than conservation, program where no East Kentucky energy is saved.[17]

The adjustment to advertising expenses as proposed by East Kentucky should be accepted. KRS 278.010(15) defines DSM as any conservation, load management, or other utility activity intended to influence the level or pattern of customer usage or demand. Thus, the ETS program is a legitimate load shifting effort that qualifies as DSM. However, to the extent that the ETS program encourages non-electric heating customers to install ETS units, the

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[15] Application Exhibit L, Adkins Prepared Testimony, at 5.

[16] Response to the Commission's Order dated December 14, 1994, Item 26 (b).

[17] Brown Kinloch Testimony, at 8. The AG criticized the ETS program during the review of East Kentucky's 1993 Integrated Resource Plan, noting that it was a load building program.

program is promotional in nature and not recoverable in rates. The AG's "conservation only" definition of DSM is more restrictive than that established by statute and will not be adopted by the Commission. Since East Kentucky has already excluded 50 percent of this advertising expense, the promotional nature of the ETS program is being recognized and not charged to ratepayers.

Directors' Fees and Expenses

East Kentucky proposed to exclude $52,004 in test-year directors' fees and expenses, basing the exclusion on Commission rate-making precedent. The AG proposed an additional reduction of $85,519 to reflect the normalization of the directors' liability insurance premiums. East Kentucky has agreed to the AG's adjustment,[18] resulting in a total reduction of $137,523.

East Kentucky has historically paid its directors per diem fees for attending meetings other than the regular board meetings and official duties. While maintaining that these fees are legitimate rate-making expenses,[19] East Kentucky acknowledged that the Commission's practice is to exclude them because they relate to optional meetings.[20] The Commission has not been persuaded to modify its past practice and will remove an additional $24,065, resulting in a total expense reduction of $161,588.

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[18] East Kentucky Brief, at 9.

[19] Response to the Commission's Order dated December 14, 1994, Item 29.

[20] T.E., Vol. I, March 28, 1995, at 117.

Other Postretirement Employee Benefits

East Kentucky requests recovery of other postretirement employee benefits ("OPEBs") under Statement of Financial Accounting Standards No. 106 ("SFAS 106"), "Employers' Accounting for Postretirement Benefits Other Than Pensions." Using a 15 percent medical trend rate, it calculated this expense to be $3,670,168.[21] The AG proposed to reduce the medical trend rate by one percent on the basis that health care cost increases moderated significantly in 1994, rendering a 15 percent trend rate inappropriate. He further argued that since OPEB expense relates to both current and retired employees, a portion should be capitalized,[22] mirroring a practice followed by most companies.[23] Combined, the AG's two adjustments would reduce test-year medical expense by $1,118,724.[24]

East Kentucky opposed the AG's adjustments on the grounds that it utilized the best available data to perform the calculation and that no portion of the expense is required to be capitalized under generally accepted accounting principles ("GAAP").[25] East Kentucky also states that health care benefits are paid to employees who are retired and thus are not working on capital projects.[26]

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21 Response to the Commission's Order dated December 14, 1994, Item 62(d), at 1 of 2.

22 DeWard Direct Testimony, at 15 and 16.

23 T.E., Vol. II, March 29, 1995, at 13.

24 DeWard Direct Testimony, Schedule 10.

25 Eames Rebuttal Testimony, at 1.

26 T.E., Vol. I, March 28, 1995, at 107.

In recognition of the recent downward trend in medical care costs, the Commission finds that 15 percent is an inappropriate trend rate and a 1 percent reduction is reasonable. In addition, East Kentucky acknowledged that SFAS 106 requires the accrual of OPEBs earned by current employees, some of whom work on capital projects.[27] Thus, capitalizing a portion of OPEBs is reasonable and appropriate.

Furthermore, East Kentucky's 6 percent administrative costs used to calculate OPEB expense includes a portion of the salaries of three employees whose full salary is already included as an expense.[28] By recalculating the OPEB expense to reflect a 1 percent reduction in the trend rate, the elimination of duplicative salaries, and then utilizing a capitalization rate of 7.59 percent, the OPEB expense is reduced by $1,166,865.

Although East Kentucky is recovering OPEBs under SFAS 106, it is not currently funding these costs, although it intends to do so.[29] Until funding begins, there will be excess cash recovered to the extent that the expense level included in rates exceeds the current cash expenses. To protect both ratepayers and employees, East Kentucky should place the excess cash in a separate account until such time as funding begins.

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[27] T.E., Vol. II, March 29, 1995, at 118.

[28] T.E., Vol. I, March 28, 1995, at 40.

[29] Response to the Commission's Order dated January 27, 1995, Item 47(b).

Supplemental Executive Retirement Plan

The AG proposed to reduce test-year expenses by $52,562 to remove the net cost of East Kentucky's Supplemental Executive Retirement Plan ("SERP"), stating that the Commission consistently removes such costs which benefit highly compensated employees beyond the pension plans provided all employees.[30] East Kentucky argues that the SERP is necessary as a meaningful incentive to retain senior management employees by supplementing their Social Security benefits and address perceived differences in the compensation levels between East Kentucky and surrounding investor-owned utilities.[31]

The Commission has reviewed the components of East Kentucky's overall compensation package and finds that it is adequate without the SERP. Excluding the test year SERP from rates reduces expenses by $42,134.[32]

Interest Expense

East Kentucky and the AG proposed numerous adjustments to test-year interest expense. The AG proposed a reduction of $2,104,455 to reflect East Kentucky's 1995 repricing of long-term debt, the amortization of the repricing premium, and estimated principal payments made during 1994.[33] East Kentucky agreed to

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[30] DeWard Direct Testimony, at 17.

[31] Response to the Commission's Order dated January 27, 1995, Item 7(b) and T.E., Vol. I, March 28, 1995, at 50.

[32] Response to Hearing Data Requests, Item 3.

[33] DeWard Direct Testimony, at 18.

reflect the 1995 debt repricing, but opposed amortizing the premium as contrary to GAAP and estimating 1994 principal payments as contrary to the use of a historic test year.[34]

The AG's proposal illustrates the problem of adjusting for events occurring long after the end of a historic test year. While one adjustment might be reasonable, all the adjustments are interrelated. Thus, one cannot be adopted without the others. For example, the interest expense reduction due to repricing cannot be recognized absent the principal balance reduction due to scheduled payments. This case was filed using a historic test year and the events incorporated in the AG's proposal occurred far beyond test-year end. Therefore, the proposal should be rejected.

PSC Assessment

East Kentucky and the AG agreed that the test-year PSC Assessment should be reduced by $44,780 to reflect the impact of East Kentucky's rate reduction which took effect on January 1, 1995. However, the assessment should also be normalized to reflect all adjustments made to East Kentucky's gross operating revenues. In addition, the normalization should reflect the fact that East Kentucky's gross operating revenues in the test year were significantly higher than those upon which the test-year assessment was based. This normalization results in an increased expense of $68,728, which must then be reduced by $53,556 to reflect the revenue reduction granted in this Order.

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[34] Eames Rebuttal Testimony, at 3 and 4.

Two Times Salary Life Insurance

East Kentucky provides term life insurance coverage for each full-time employee in an amount twice the employee's January 1 base salary rounded to the next $500. No employee contribution is required for this coverage. East Kentucky maintained that providing this level of coverage is common industry practice and that it annually compares its compensation and benefit packages with those of surrounding businesses and utilities. Based on those comparisons, East Kentucky stated that providing two times base salary life insurance is necessary and appropriate.[35] However, it acknowledged that its current wage and salary plan was implemented in 1981 and a full review is not expected to occur before the last half of 1996.[36]

Under current federal law, the cost for insurance coverage in excess of $50,000 constitutes wages subject to FICA taxes.[37] Once the $50,000 coverage level is reached, an employer incurs additional FICA tax expense. To include the expenses associated with employee life insurance coverage in excess of $50,000, utilities must clearly demonstrate the need for this additional compensation. East Kentucky's annual comparisons do not demonstrate the need for this compensation. Therefore, life insurance premium expense should be limited to the cost to provide

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[35] T.E., Vol. I, March 28, 1995, at 51.

[36] Response to the Commission's Order dated January 27, 1995, Item 11(b).

[37] 26 U.S.C. § 79 (1992).

each full-time employee with two times salary coverage up to $50,000. This results in a $64,573 reduction in operating expenses. A corresponding reduction of $3,712 should be made to test-year FICA tax expense.

The effect of the pro forma adjustments on East Kentucky's net income is as follows:[38]

	Actual Test Period	Pro Forma Adjustments	Adjusted Test Period
Operating Revenues	$344,379,928	$ 9,853,298	$354,233,226
Operating Expenses	251,393,487	13,638,439	265,031,926
Net Operating Income	92,986,441	(3,785,141)	89,201,300
Interest on Long-Term Debt	55,674,353	(2,408,774)	53,265,579
Other Income and (Deductions) - Net	(59,441,371)	64,935,945	5,494,574
NET INCOME	$(22,129,283)	$ 63,559,578	$ 41,430,295

REVENUE REQUIREMENTS

The actual rate of return on East Kentucky's net investment rate base for the test year was 1.15 percent and its actual Times Interest Earned Ratio ("TIER") for the test year was .60X. It requested rates that would produce a TIER of 1.15X and a rate of return of 7.37 percent on its proposed rate base of $676,005,598.

East Kentucky stated that its proposed 1.15X TIER was the minimum level needed to serve its customers and that it was the same level allowed in its last general rate case.[39] It also cited

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[38] In accord with East Kentucky's agreement with the AG, expenses have been reduced by an additional $227,984 to remove non-recurring items.

[39] Response to the Commission's Order dated December 14, 1994, Item 38.

changes in RUS minimum TIER requirements necessary for it to qualify for FFB financing[40] and the required implementation of an equity development plan to achieve a 20 percent equity level.[41]

The AG proposed a 1.10 TIER, arguing that East Kentucky's lower interest costs and cancellation of the J. K. Smith Plant make the circumstances today significantly different from those which existed at the time of its last general rate case. He also noted East Kentucky's increased number of customers and suggested that East Kentucky had been overearning for a number of years. Referring to RUS's requirement to build equity levels, the AG stated that RUS should not be concerned about the financial strength of East Kentucky.[42]

Revenue requirements calculated to produce a TIER of 1.15X should be approved. While the TIER level authorized in a previous rate case is of limited relevance, the additional financial requirements established by East Kentucky's principle lender, RUS, must be recognized. To achieve a 1.15X TIER, East Kentucky must reduce its annual revenues by $33,493,930, or $5,488,567 more than the reduction effective on January 1, 1995. This reduction in revenue should produce net income of $7,989,921, which should be

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[40] Id., Item 37. 7 CFR 1710 requires G&TCC to maintain a 1.05 TIER to qualify for FFB financing.

[41] Response to the Commission's Order dated January 27, 1995, Item 25. The equity development plan has a 10-year planning horizon, which is to designed to make reasonable progress toward achieving an equity of 20 percent.

[42] DeWard Direct Testimony at 21.

sufficient to meet East Kentucky's operating needs and the requirements of servicing its long-term debt. This reduction in revenue will result in a 8.41 percent rate of return on net investment rate base.

PRICING AND TARIFF ISSUES

Cost-of-Service Study

East Kentucky filed an embedded cost-of-service study which forms the basis for its proposed allocation of costs and the determination of the revenue requirements for its wholesale rate schedules. In the study, East Kentucky combined the functionalization and classification of costs into a single step. Production energy and Spurlock energy costs are considered to be energy-related. Distribution substation costs are considered to be customer-related, while member and accounting services are classified as energy-related. All other functional cost areas are considered to be demand-related.

After first allocating energy and demand costs to the steam operations of Inland, all other costs were allocated to the electric rate schedules. Energy-related costs were allocated to each rate schedule as a percent of total energy. Demand-related costs were allocated to each schedule using the "average and excess" method which allocates part of the demand-related costs on average demand or energy, and the other costs on excess demand. Distribution substation costs were used to develop a separate metering point charge and load center charge.

The AG criticized certain aspects of East Kentucky's cost-of-service study, primarily the way in which it applied the average and excess demand methodology. While agreeing that this methodology is appropriate, the AG asserted that East Kentucky used coincident peak demand instead of non-coincident peak demand to allocate the excess demand component. He cited the 1992 *Electric Utility Cost Allocation Manual* of the National Association of Regulatory Utility Commissioners ("NARUC") in contending that use of coincident peak demand in allocating excess demand produces an allocation that is identical to one derived using a coincident peak ("CP") methodology. The AG opposes using a CP methodology because no consideration is given to average load in allocating demand-related costs. He also contended that use of the average and excess methodology is biased in favor of high load factor customers and recommended recalculating average and excess demand allocators using non-coincident peak.

East Kentucky explained that, instead of using a single CP in its calculation as asserted by the AG, it used a member system's largest contribution to the system's monthly CP during the test year, by rate schedule. This method was chosen because East Kentucky proposes to bill on the basis of CP.

East Kentucky compared the various demand allocation methodologies and showed that its and the AG's resulted in practically identical allocation percentages. East Kentucky also agreed to allocate the rate decrease by the average and excess method based on non-coincident peak demand as advocated by the AG.

The average and excess method using non-coincident peaks to allocate demand-related costs is consistent with the methodology recommended by NARUC. Therefore East Kentucky's cost-of-service study, using this method, should be accepted for allocating the rate decrease to the wholesale rate schedules.

Revenue Allocation

East Kentucky proposed to use its cost-of-service study to allocate the first $14 million of its proposed decrease[43] and to allocate the remainder, which recognizes revenues from other sources, in proportion to the revenue requirements for each rate class with Inland included at full revenues. The AG initially proposed allocating the decrease, based on revenue, through equal percentage reductions for all rate classes. However, in his brief, he proposed using the results of the average and excess cost-of-service approach, based on non-coincident peak demands, to allocate the first $14 million, and using class revenue requirements, recognizing the Inland EDR discounts, to allocate the remainder.

The decision on cost-of-service methodology dictates the manner in which the first $14 million of the decrease will be allocated. For the remainder, the allocation should be based on wholesale class revenue requirements with Inland included at full revenues. Recognizing the EDR discounts, as the AG proposes, introduces a bias against Inland in this rate decrease case which would work equally in Inland's favor in an application for a rate

[43] This amount reflected the difference between the revenue requirements and normalized revenues for each rate class.

increase. There is insufficient justification to incorporate such a bias into the allocation process. Using full revenues will produce an allocation appropriate for either a rate increase or decrease.

Rate Design

East Kentucky proposed several changes to its existing rate design.[44] For Rate Schedules A, B, and C, and the contract rate for Inland, it proposed to maintain its existing rate design and effect allocated decreases by reducing energy charges. Consistent with his original revenue allocation proposal, the AG recommended that demand and energy charges receive equal percentage reductions. Maintaining the existing rate structures, with the decreases made via reductions in energy charges only, is reasonable, will further the Commission's goal of rate stability, and will equitably distribute the reduction. East Kentucky's proposal should be approved.

East Kentucky's most extensive changes were proposed for Rate Schedule E, which serves over 95 percent of its system's ultimate retail customers. It proposed to: (1) establish on-peak and off-peak billing periods with differing energy rates; (2) increase its demand charge from $4.34 per KW to $7.06 per KW, based on marginal capacity costs; (3) set its off-peak energy rate equal to its variable cost of production (with no fixed cost recovery); and (4) set its on-peak energy rate at the level necessary to generate the

[44] Meter and substation charges, which were not challenged, are acceptable and should be approved.

remainder of its total Schedule E revenue requirement above the revenues being generated through its demand charge and off-peak energy rate. This proposed rate design is intended to provide maximum flexibility to its member systems to implement time-of-day retail rates and to establish an on-peak price signal with attractive off-peak rates to encourage load shifting to off-peak periods.

The AG opposed these changes contending that there is no need to shift load as suggested by East Kentucky. He argues that the Schedule E rate design should reflect actual embedded costs based on his recommended cost-of-service approach and maintains that off-peak rates should recover the variable cost of production plus make a contribution to fixed costs. Further, the AG claims that a full allocation of fixed costs would result in an off-peak energy rate of 2.72 cents per kilowatt-hour which is 50 percent greater than East Kentucky's variable production cost. He recommends that all Schedule E energy sales be priced at the embedded off-peak cost of 2.72 cents per kilowatt-hour and that the demand charge be set at the level necessary to generate the remainder of the class revenue requirement.

East Kentucky's attempts to shift load off-peak, thus reducing the need for new base load capacity, are commendable and the use of marginal capacity costs to establish demand charges is a legitimate approach to meet this goal. The Commission is not persuaded by the AG's argument that, by shifting load off-peak, East Kentucky will need to operate its high-cost peaking units during off-peak hours.

The Schedule E demand rate should be approved as proposed by East Kentucky.

The Commission does find merit in the AG's position that off-peak rates should include some contribution to fixed costs. Therefore, the off-peak energy rate should be set at East Kentucky's variable cost of production plus 10 percent. The on-peak energy rate should be set to recover the remainder of the Schedule E revenue requirement.

Billing and Tariff Changes

East Kentucky proposes to change its demand measurement for billing purposes from non-coincident peak to coincident peak demand. For its Schedule B and C tariffs, East Kentucky proposes to lower the minimum contract demand from 1,000 KW to 500 KW and lower the minimum energy from 425 KWH to 400 KWH per KW of billing demand. In addition, East Kentucky proposes to modify its Schedule B and C tariffs so that consumers using less energy than the contract minimum will be billed the difference between the tariffed energy rate and the base fuel rate for their unused energy.

These changes and other less significant tariff text changes proposed by East Kentucky were not contested. The Commission has reviewed them and finds them to be reasonable. As they are being approved as proposed, the text changes are not included in the attached rate appendix.

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix B are the fair, just, and reasonable rates for East Kentucky to charge for service rendered on and after the date of this Order.

2. The rate of return and TIER granted herein are fair, just, and reasonable and will provide for East Kentucky's financial obligations.

3. The rates proposed by East Kentucky will produce revenue in excess of that found reasonable herein and should be denied.

IT IS THEREFORE ORDERED that:

1. The rates in Appendix B are approved for service rendered by East Kentucky on and after the date of this Order.

2. The rates proposed by East Kentucky are denied.

3. East Kentucky shall reflect the cost of the CT project as a credit on customers' bills and shall reduce such credit by one-third as each unit enters commercial operation.

4. Within 30 days from the date of this Order, East Kentucky shall file with the Commission its revised tariff sheets setting out its approved rates.

5. Within 2 years from the date of this Order, East Kentucky shall complete a depreciation study of its entire utility plant and shall file a copy of the study with the Commission within 30 days of its completion.

6. From this day forward, East Kentucky shall deposit in a separate account the difference between the pay-as-you-go amount

for OPEBs and the level included in rates until such costs are fully funded.

Done at Frankfort, Kentucky, this 25th day of July, 1995.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 94-336 DATED JULY 25, 1995

East Kentucky Power Cooperative, Inc. has been granted a rate decrease of $33,493,930. The decrease for each of the distribution cooperatives served by East Kentucky Power Cooperative, Inc. is set forth below.

Cooperative Name	Amount
Big Sandy R.E.C.C.	$ 1,208,390
Blue Grass R.E.C.C.	2,130,947
Clark R.E.C.C.	1,545,378
Cumberland Valley R.E.C.C.	2,464,918
Farmers R.E.C.C.	1,523,814
Fleming-Mason R.E.C.C.	2,873,299
Fox Creek R.E.C.C.	665,906
Grayson R.E.C.C.	930,846
Harrison County R.E.C.C.	851,034
Inter-County R.E.C.C.	1,205,531
Jackson County R.E.C.C.	3,214,744
Licking Valley R.E.C.C.	1,048,247
Nolin R.E.C.C.	2,290,342
Owen Electric Cooperative	2,741,625
Salt River Electric Cooperative	2,725,703
Shelby R.E.C.C.	1,184,417
South Kentucky R.E.C.C.	3,317,233
Taylor County R.E.C.C.	1,571,428
Total - All Cooperatives *	$33,493,802

* Difference in total due to rounding in the calculation of East Kentucky's rates

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 94-336 DATED JULY 25, 1995

The following rates and charges are prescribed for the member system cooperatives served by East Kentucky Power Cooperative, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

WHOLESALE POWER RATE SCHEDULE

Monthly Rate

Metering Point Charge:

1. Applicable to all metering points and to all substations
2. Charge: $125.00

Substation Charge:

1. Applicable to each substation based on its size
2. Charges:

1,000 to 2,999 kVA substation	$ 944.00
3,000 to 7,499 kVA substation	2,373.00
7,500 to 14,999 kVA substation	2,855.00
15,000 and over kVA substation	4,605.00

Section A

Monthly Rate - Per Load Center

Demand Charge per KW of Billing Demand	$7.82
Energy Charge per KWH	$0.020127

Section B

Monthly Rate

Demand Charge per KW of Contract Demand	$5.39
Demand Charge per KW for Billing Demand in Excess of Contract Demand	$7.82
Energy Charge per KWH	$0.020127

Section C

Monthly Rate

Demand Charge per KW of Billing Demand	$5.39
Energy Charge per KWH	$0.020127

Section E

Monthly Rate - Per Load Center

Demand Charge per KW of Billing Demand	$7.06
Energy Charge per KWH:	
On-Peak	$0.020080
Off-Peak	$0.019822

Inland Container - Electric

Energy Charge per KWH	$0.018020